

# Torys on Income Trusts

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## Draft Conversion Rules for Income Trusts in Canada: Technical Commentary

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On July 14, 2008, the Department of Finance released the proposed “conversion rules” for income funds. The draft rules are designed to permit income funds to “convert” into public corporations and wind up without triggering adverse tax consequences to the income fund and its unitholders.

The proposals generally provide for alternative methods whereby an income fund can convert to a public corporation. The distinguishing feature of the first alternative is that the income fund owns only shares of a corporation and distributes these to its unitholders; the corporation then becomes the public corporation on the windup of the income fund. The distinguishing feature of the second alternative is that a corporation acquires all the units of the income fund from the unitholders in exchange for its shares, becoming the sole unitholder of the income fund, which is then wound up.

The draft proposals are subject to comments by interested parties by September 15, 2008. These proposals will no doubt be revised before being enacted into law. It is not known when this would happen, but when enacted, the proposals are expected to cover transactions that occur within the periods described below, generally after the Announcement Date (July 14, 2008) and before 2013.

The following summarizes the highlights of the alternative methods.

### The First Alternative: Income Fund Distributes Shares of a Corporation to Its Unitholders

The first alternative is, in some ways, the simpler one. This method requires the income fund to own property that consists only of shares of a taxable Canadian corporation. As a practical matter, this alternative will generally require the income fund to reorganize the ownership of its assets (to the extent required) so that it ends up owning only shares of a corporation. For example, if the income fund already owns only shares and debt of a corporation (the so-called first-generation structures), the debt would have to be capitalized and transformed into additional shares of the corporation. If the income fund owns a partnership, directly or indirectly (the so-called second-generation or third-generation structures), it would have to incorporate the partnership or transfer the partnership to a corporation for shares of a corporation (these steps can be done on a tax-deferred basis under current rules). Once the income fund owns only shares of a corporation, the proposals provide for the income fund to distribute those shares to its unitholders on the winding up of the income fund in a manner that does not give rise to any adverse tax consequences to the income fund or its unitholders. In particular, (a) the income fund is considered to have disposed of the

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shares for proceeds equal to the cost of the shares to the income fund; (b) a unitholder is deemed to have disposed of its units for proceeds equal to the cost of the units to the unitholder; and (c) public unitholders are generally considered to have acquired the shares of the corporation for a cost equal to the cost of their units.

The draft proposals for the first alternative also provide for the case where the income fund is the sole beneficiary of a “subtrust,” which in turn owns property (typical in the second-generation structures). Similar rules apply to the subtrust to permit it (once it owns only shares of a corporation) to distribute shares of a corporation to its sole beneficiary (the income fund) on the windup of the subtrust in a tax-free manner. The income fund can then in turn distribute the shares of the corporation to its unitholders and wind up on a tax-free basis as described above. In this case, the draft proposals provide that the “distribution” by the income fund on the ultimate windup of the income fund must generally occur over a 60-day period that begins with the distribution of property by the subtrust to the income fund.

The first alternative applies to transactions that occur after the Announcement Date and before 2013. However, the draft proposals provide that income fund entities that qualify for the first alternative include an income fund that would have been a “SIFT trust” (a “specified investment flow-through trust”), or a trust that qualified for the REIT exception, at any time during the period that began on October 31, 2006 and ended on the Announcement Date (without regard to the transitional rules in the SIFT legislation). As a practical matter, all income funds in existence on October 31, 2006, should qualify.

As noted, the first alternative requires the income fund to own only shares of a corporation. In certain situations, it may not be practical or feasible (including for non-tax-related reasons) for an income fund to reorganize the ownership of its assets in this manner. In addition, the first alternative does not provide for the preservation of “tax attributes” of the income fund vehicle itself (such as loss carryforwards of the income fund), which would simply be lost on the windup of the income fund. The second alternative addresses these issues to some degree.

## **The Second Alternative: Corporation Acquires All the Units of the Income Fund**

The second alternative (in its simplest version) generally begins with a corporation acquiring all the units of the income fund in a “share for income fund unit” exchange, resulting in the corporation becoming the sole unitholder of the income fund. The draft proposals provide that the corporation must acquire all the units of the income fund within a 60-day period (or all the units of the income fund must be redeemed or cancelled within a 60-day period). This exchange and the rules relating to it are very much modelled on the existing “share for share exchange” rules (in section 85.1 of the *Income Tax Act*), but there are important differences. The unitholder must (within the 60-day exchange period) dispose of all its units of the income fund to the corporation and must not receive any consideration other than shares of the corporation in return for the income fund units. There are two additional and “new” conditions (as compared with the “share for share” exchange rules): (a) the shares that the unitholder receives must have a fair market value at the time of issuance that is equal to the fair market value of the income fund units immediately before the exchange; and (b) all the exchange shares issued to unitholders of the income fund must be shares of a single class of shares of the corporation. The fair market value test should be relatively easy to satisfy in the simple case in which the corporation is a newly formed entity set up solely to acquire the income fund units; but this test may well present difficulties if the corporation is an existing corporation that has other assets and businesses (such as a third-party corporate acquiror of the income fund).

If the exchange otherwise qualifies, the draft proposals provide that the “elective” rollover provisions do not apply (so that joint elections between the corporation and the unitholders under section 85 of the

*Income Tax Act* are not required) and the rollover is automatic. In particular, a unitholder is considered to have disposed of the units for proceeds equal to the cost of the units to the unitholder, and the unitholder is considered to have acquired the exchange shares at a cost equal to such cost amount. In keeping with the share-for-share exchange rules, the corporation is considered to have acquired the units of the income fund for an amount equal to the lesser of the fair market value of the units and an analogue of the “paid-up capital” concept that normally applies to shares of a corporation that is extended to units of an income fund. The paid-up capital analogue for the income fund units is calculated as the difference between the fair market value of the property received by the income fund for the issuance of the units and the amounts payable by the income fund on the units (to any holder thereof), otherwise than out of income or capital gains of the income fund. The paid-up capital analogue for income fund units is also relevant in determining the paid-up capital of the exchange shares issued by the corporation in exchange for the income fund units. In general, the draft proposals provide that the paid-up capital of the exchange shares is limited to the paid-up capital analogue of the income fund units acquired in the exchange. The calculation of the paid-up capital analogue for income fund units may well prove to be challenging.

The draft proposals relating to the exchange apply to transactions that occur after the Announcement Date and before 2013. However, the exchange rules may also apply to transactions that occurred on or after December 20, 2007 and before the Announcement Date if the corporation elects in a timely manner to have the exchange rules apply (on or before the filing due date for the corporation's tax return for the year in which royal assent is received to the enacting legislation). If, in the meantime, elections have been filed under section 85 of the *Income Tax Act* between the corporation and unitholders, the election to have the exchange rules apply must be jointly made by the corporation and each unitholder.

It may be possible to effect the kind of exchange contemplated under the second alternative in the more traditional manner (by relying on elections under section 85 of the *Income Tax Act* between the corporation and unitholders), but it appears that such an exchange would have to be designed to “break” the automatic exchange provided for in the second alternative, which would otherwise govern (by not complying, in some minor fashion, with one of the conditions). This would possibly provide another way to achieve the situation in which a corporation is the sole beneficiary of the income fund if the conditions and consequences associated with the proposed exchange rules prove to be problematic.

A further step is needed after a corporation becomes the sole beneficiary of the income fund in order to wind up or eliminate the income fund from the structure in a tax-free manner. If the income fund has structured or can structure the ownership of its assets so that it owns only shares of a corporation, the income fund should be able to position itself so that it can distribute the shares of the “underneath” corporation to the sole unitholder “top corporation” and wind up in a tax-free manner by using the first alternative described above. However, an alternative next step is provided for in the draft proposals in the case where the only beneficiary of the income trust is a corporation. This next step involves a windup of the income fund under proposed rules that are modelled on the existing rules (in subsection 88(1) of the *Income Tax Act*) relating to the tax-free windup of a subsidiary corporation into its parent corporation. These windup rules do not require the only asset of the income fund to consist of shares of a corporation, but do require that the only beneficiary of the income fund be a corporation.

These windup rules treat the income fund as if it were a subsidiary corporation that is being wound up into its parent corporation and “import” the existing rules under subsection 88(1) with suitable modifications as necessary. In general, these rules will provide that (a) the assets of the income fund are considered to have been disposed of by the income fund for proceeds equal to the cost of such assets to the income fund; (b) the corporate parent is considered to have acquired such assets at a cost equal to that cost amount (subject to the possible application of the “bump” rules to qualifying assets); and (c) the corporate parent is generally considered to have disposed of the units of the income fund for proceeds

equal to the cost of such units to the corporate parent. The actual rule in (c) is more complex and brings into play the paid-up capital analogue concept for units of the income fund (as described above) in that the units of the income fund are considered to be shares of a subsidiary corporation that have a paid-up capital determined by the analogue described above. The tax-free disposition of such units to the corporate parent will follow, provided that the cost of the units of the income fund to the corporate parent is greater than the paid-up capital analogue of the units of the income fund. Caution may be required here, given that if the corporate parent acquired the units of the income fund under the proposed new exchange rules described above, the cost of the units is limited by the paid-up capital analogue of the income fund units.

The additional advantage of these windup rules is that they provide for continuity of “tax attributes” of the income fund in the corporate parent, including loss carryforwards of the income fund. This addresses one of the limitations of the first alternative described above.

This set of windup rules also take into account the situation in which the income fund may wholly own a subtrust (the second-generation structure). The rules provide for the subtrust to distribute its property and wind up on a tax-free basis under the same set of windup rules followed by a windup of the income fund under such rules. In general, where the transactions begin with a distribution of property by a subtrust, the winding up of the income fund must occur within a 60-day period, commencing at the time of the subtrust distribution.

These windup rules generally apply to transactions that occur after the Announcement Date and before 2013. However, income funds that qualify for such rules include an income fund that would have been a SIFT trust, or a trust that qualified for the REIT exception, at any time during the period that began on October 31, 2006 and ended on the Announcement Date (without regard to the transitional rules in the SIFT legislation). This means that an income fund in existence on October 31, 2006, that converted before the Announcement Date and found itself with a single corporate beneficiary may be able to use these rules (if otherwise available) to wind up on a tax-free basis.

## Miscellaneous Matters

The draft proposals do not generally deal with the issue whether an “acquisition of control” of corporations within the income fund structure occurs on the conversion of the income fund into a corporation. A helpful rule is provided in the situation in which a subtrust distributes shares of a corporation that it owns to the income fund as part of the windup of the subtrust. That distribution could otherwise result in the income fund acquiring control of the corporation, but the helpful rule provides that the income fund is not deemed to have acquired control of the corporation because of the distribution. However, the rules do not address the more general question whether there is an acquisition of control of corporations owned by the income fund on the windup of the income fund. Arguably, the windup rules under the second alternative are not intended to give rise to an acquisition of control of the income fund (viewed as a corporation with tax attributes) or corporations controlled by the income fund; however, this is not clear. An acquisition of control would generally have negative consequences on the ability to use loss carryforwards and other tax attributes in the future.

The draft proposals provide a “rollover” rule for options in respect of income fund units that are exchanged for options to acquire shares of the new public corporation resulting from the conversion of the income fund.

The draft proposals provide for a rule that permits debt of a subtrust to be settled (on the windup of the subtrust) in a way that will not give rise to debt-forgiveness consequences in appropriate circumstances.

The draft proposals do not, however, appear to provide for similar rules with respect to the settlement of debt of a corporation owned by the income fund.

The draft proposals provide that the exchange described above also applies to a SIFT that is a partnership so that a SIFT partnership can convert to a public corporation by means of such an exchange of shares for limited partnership units (including a paid-up capital analogue rule for partnership units). The alternative windup rules described above for a SIFT trust once owned by a corporation do not, however, extend to a SIFT partnership whose limited partnership units are owned by a corporation; but this is understandable since existing rules in the *Income Tax Act* can be used to wind up a partnership or otherwise incorporate a partnership on a tax-free basis. **1**